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Inequality in Australia

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Introduction

Australia has a reputation for egalitarianism. It is not deserved.

This is a nation based on mercantilist plunder. Two hundred and fifty years after the publication of Adam Smith's *The Wealth of Nations* (Smith, 1776), our leaders insist that the prosperity of citizens rests upon a trickling down of bounty from the export of raw materials.[2] This simplistic narrative is told, and retold, by almost every newspaper editor in the country, over and over again, in the form of a Gregorian chant without end.

Economists are uncomfortable with this story. But I wonder how many Australians understand how our celebration of mercantilist plunder has contributed to an erosion of the nation's manufacturing capability, undermined labour productivity growth, and depressed the living standards of workers. I wonder how many understand how this narrative has contributed to growing inequality in Australia, especially as between successive generations.

Australians are aware that the living standards of today's workers are under pressure. They now have lived experience of the impacts of climate change and large-scale environmental degradation. They know that these impacts are getting worse, and that they will be much worse for their children and grandchildren. And they are aware of a growing concentration of wealth, increasingly in the hands of those who have privileged access to the continent's natural resource stocks, and those who no longer must work for a living.

These developments are part of a broader intergenerational tragedy that also features young workers being denied a reasonable prospect of home ownership; young workers burdened by mountains of public debt, the punishing costs of securing a tertiary education and the need to satisfy the increasing demands of "credentialism;" young workers held back by a tax system that relies increasingly upon fiscal drag. Young workers, a declining proportion of the population, are having to pick up the tab.

Why has this been tolerated?

One explanation, voiced often in various groups concerned by what they see happening around them, is that all these things are the consequence of market systems designed by heartless neoclassical economists, prisoners of abstract theories.

That perspective is understandable. But the truth is much worse than that. The

1 Former Secretary of the Treasury, Australian Government; Former Chair, National Australia Bank. This presentation was the first in the RSNSW Lunchtime series: Provocations and Inspirations, see https://www.youtube.com/watch?v=8RUUFEwI-e4&t=5066s. The talk has been referenced in the *Australian Financial Review* (Kehoe 2024).

2 Smith (1776) rebutted the arguments of the mercantilists, who had argued, inter alia, that a country's wealth derived from its exports (in this case of iron ore, coal and gas). [Ed.]

intergenerational tragedy playing out in Australia could have been avoided had our political system not been so dysfunctional, its leaders less inclined to turn a deaf ear to well-reasoned policy advice drawn from the textbooks of neoclassical economics.

But we shouldn't blame our political leaders either. After all, they are the product of a democratic system. Instead, we need to look at those who elect them; we need to look at ourselves: all of us.

Every generation of Australians since the first wave of European settlement has celebrated plunder, dumb luck, and "finders keepers." This is what we mean by "a fair go." In considering the merits of any policy proposal, every generation of Australians accorded the privilege of suffrage has only ever asked one question: what's in it for me? And because we celebrate plunder, we idolise those who plunder the most. They are our role models.

There is no Australian success story more wholeheartedly celebrated than the export of something taken from nature. Because our political leaders know this, they work hard to be seen to be complicit in these stories. An instructive example is then Prime Minister John Howard's wanting to take some credit for the announcement, on 8 August 2002, of a 25-year Australian LNG supply contract to China.[3] According to Mr Howard, persuading China to relieve us of some of the burden of our natural gas reserves was "a great Australian team effort." Team Australia. All of us.

Two decades later, Australia is the world's second largest exporter of natural gas, and the fossil fuel industry is warning that we don't have enough gas available domestically to heat homes on the east coast of Australia. So, a gas import terminal is being constructed on the NSW coast. Apparently, it should be underwritten by the Australian taxpayer. This is the sort of game Team Australia plays.

It is time to ask ourselves some serious questions about the consequences of our "fair go" ethos. Questions like these: why have we supported a set of public policies that has heavily degraded the natural environment; energised a drift of wealth away from workers, in favour of retirees, property owners and mercantile interests; and entrenched an economic structure that, for two decades, has delivered very low productivity growth and even weaker real wages growth?

Over the first two decades of the 21st century, as productivity growth slowed sharply, the structurally adjusted level of Commonwealth Government spending accelerated, increasing at almost precisely the rate projected in the first *Intergenerational Report*, published in 2002.[4] And, despite the warnings written into the *Intergenerational Report*, the tax system that Australian governments have been relying upon to support that spending is in much worse shape today than it was then. There has been no structural reform of the tax system in the past 24 years. For more than two decades, we have been on notice that our tax system will prove incapable of delivering what will be asked of it. But we just couldn't be bothered.

The present generation of Australians faces a reckoning. This is the first generation unable to make a credible claim that future

3 https://pmtranscripts.pmc.gov.au/release/transcript-12872

4 https://treasury.gov.au/sites/default/files/2019-03/2002-IGR-report.pdf

generations of Australians will be better off than they are.

That's a serious matter. An inability to make that claim threatens a key pillar of the social compact upon which the legitimacy of our democratic system of governance depends.

There is a narrow pathway out of this emergent intergenerational tragedy, and the threat it poses to Australian democracy. But navigating it will not be easy. It will take uncommon leadership that makes the case for this generation not merely asking what is in it for them, but instead, doing what they can to secure prosperity for future generations of Australians.

Political power, national endowments, individual capability and inequality

Inequality in the distribution of political power is a matter that has concerned moral philosophers and economists for hundreds of years. Two dimensions have been the focus of most attention: short-termism and corporatism.

Short-termism is a consequence of the inescapable "fact of life" that only the present generation has access to political power, a fact that necessarily poses a considerable risk to those not yet born. And the unhealthy consequences of corporatism were the principal motivator for Adam Smith's *The Wealth of Nations*.

In his book, *The Price of Inequality*, Joe Stiglitz (2013) draws attention to some of the *capabilities* required of individual agents if they are to be relied upon to generate acceptable aggregate outcomes. And he makes a strong public policy case for the nurturing of those capabilities.

The importance of an emphasis on capabilities has long been articulated by Amartya Sen.[5] The capabilities perspective is central to the Stiglitz-Sen-Fitoussi Commission's report, published 15 years ago, on the measurement of economic performance and social progress (Stiglitz et al., 2009).

Sen emphasises individual capability not only because of its implications for aggregate outcomes, but because individual capability is a matter of primary interest in itself; indeed, *the* primary matter in any discussion of inequality. According to Sen, the core concern should be the extent to which individuals enjoy a set of capabilities that provides them the freedom to choose a life they have reason to value.[6]

The political system can pander to sectional interests for a very long time, as Australia's patronage of its extractive industries illustrates. Yet, it would be prudent to assume that the legitimacy of a political system is fragile. Paraphrasing Sen and Stiglitz, I would venture that trust in democracy is underwritten by a social compact in the nature of a golden rule in two parts: first, all citizens in the present generation should have capabilities that allow them to lead lives they have reason to value; and, second, the present generation, being the only generation with political power, will do what it can to ensure that future generations are even better off.

The capabilities enjoyed by citizens are underwritten by national endowments. Some of these national endowments are a consequence of nature, components of "nat-

5 See, for example, Sen (1992, 1999).

6 This perspective derives from Amartya Sen's exposition of development as freedom (Sen, 1999).

ural capital." Others have been developed by earlier generations of humans. These include the products of foundational investments in such things as: our rich indigenous cultures; modern multiculturalism; the visual and performing arts; our legal and regulatory structures; education and health facilities; systems supporting research and innovation; economic and social infrastructure; physical and financial capital; policy frameworks that promote freedom and economic security; and working conditions that support human dignity.[7]

Investments in national endowments should be designed to expand opportunity and enhance the freedom of all Australians, including those not yet born, to choose a life they will have reason to value.

Capability deprivation provides a powerful explanation for extreme inequality. For example, indigenous disadvantage is overwhelmingly a consequence of a lack of access to the nation's endowments, both natural and created.

And our appalling record of species extinction constitutes another form of capability deprivation with generational distributional consequence: because of species extinction, the present generation, and all future generations, have been denied access to national endowments to which past generations had access.[8]

Of course, equality of access to national endowments does not necessarily mean that all citizens will have the same opportunity and freedom to choose a life they will have reason to value. But a lack of equal access, unless it is calibrated to compensate for all instances of innate disadvantage (in a manner that would be favoured by John Rawls (1971), for example), does mean that some will be denied the capability to choose a life of value. This form of capability deprivation should be assessed both spatially (as among different groups in society, for example) and temporally; specifically, in intergenerational terms.

The foundational role played by natural capital

Human progress, measured in economic or broader social terms, has relied upon models of industrial production, including agriculture, based on the extraction of non-renewable raw materials like iron ore, coal and gas, and the absorption of a stream of "ecosystem services" derived from things like fresh water, forests, marine life, arable soils, and various natural waste absorbers.

How might we assess whether human progress, relying upon these modes of development, is sustainable?

The Brundtland Report (1987) framed sustainable development in intergenerational equity terms: development that deprives

7 National endowments are not the sole determinants of economic, social and environmental outcomes, of course. External drivers and shapers also impact national outcomes. Notable among current shapers of Australian outcomes are the information and communications revolution; global climate change; and the industrialisation and urbanisation of China. And outcomes are impacted, too, by all the current policy settings of government, only some of which would properly be characterised as foundational investments.

8 The endowment in this latter case might be thought of as the opportunity to appreciate (that is, to derive psychic value from) the existence of the species now extinct. As Amartya Sen (2004) reminds us, in the loss of a species there is a loss of opportunity to appreciate its existence. And in that loss of opportunity there is a loss of freedom: a loss of "freedom to have — or safeguard — what (we) value and to which (we) have reason to attach importance."

future generations of the ability to meet their *needs* cannot be considered sustainable.

In an address, economist Robert Solow (1991) offered the perspective that sustainability "is (a moral) obligation to conduct ourselves so that we leave to the future the *option* or the *capacity* to be as *well off* as we are" (my emphasis).

Thus, Solow, too, couches sustainable development in intergenerational equity terms. But his concept of well-being goes beyond human *needs*. It includes an appreciation of environmental amenity, or what he calls "our desire for unspoiled nature."

Solow notes, reasonably, that when we think about our own well-being, or that of our family, our community, or even the well-being of the present generation, we should "recognize that different amenities really are, to some extent, substitutable for one another." Thus, we might see an opportunity for enhanced well-being in trading-off some amount of environmental amenity, some chunk of natural capital, for economic and/or social advancement. For example, we might choose to substitute a year's supply of firewood for the environmental amenity derived from a 500-year-old eucalypt.

These are the sorts of choices humans have been making for centuries: choosing to plunder the environment in the interests of economic and social progress; of individuals, families, and communities. It's been the rational thing to do, an easy choice to make; after all, it's not something any of us has had to pay for, until now.

Today, all the ecosystem services supplied by nature that are critical to human development are facing a set of extreme challenges, from climate change, loss of biodiversity, deforestation, and the collapse of ecosystem functioning.

These challenges pose existential risks to businesses, economies, and financial systems everywhere on Earth. Employment opportunities are being impacted and productivity undermined. Accumulated stores of material and financial wealth are exposed to nature risks so extreme as to be uninsurable. Human cultures, livelihoods and lives are being lost.

So much for sustainable development.

The 1992 Rio Earth Summit conceptualised the sustainability challenge in terms of "integrating and *balancing* economic, social and environmental concerns in meeting our needs" (my emphasis).[9]

This framing has never made sense.

We should have been constructing models of development that acknowledge the biophysical *limits* of a finite planet; models that recognise that those limits constitute a set of immutable *constraints* affecting modes of human development; that the state of the environment is not merely one among many *choice variables* that humans might play around with in various "trade-offs" and "balancing" acts, over and over, without end.

In embracing the language of "balancing" and "trade-offs," policy makers have accepted the notion that human development rests on the continuing plunder of natural capital. It is well past time we understood that securing economic and social development rests upon the rebuilding of natural capital, not its continuing plunder.[10]

This is a matter of primary distributional importance. The rebuilding of natural capi-

9 United Nations Conference on Environment and Development (UNCED), Rio de Janeiro, Brazil, 3–14 June 1992. https://www.un.org/en/conferences/environment/rio1992.

10 See (Henry et al., 2023). [Ed.]

tal, often referred to these days as "nature positive," provides an opportunity for this generation to affirm its moral obligation to future generations, to ensure that, in Solow's words, "we leave to the future the option or the capacity to be as well off as we are."

The functional distribution of income

An obvious feature of the capitalist system is that it tends to generate an ongoing accumulation of physical capital through saving and investment. Ironically, the fact that it has tended also to degrade the stock of natural capital has received far less attention from economists than the question of what the process of capital accumulation does to the distribution of income as between capitalists and workers. This "functional" distribution of income was a rather obvious interest of Karl Marx.

In more recent times, the French economist, Thomas Piketty (2014), has argued that because the rate of return on capital has typically exceeded the rate of workforce growth, we should expect to see the distribution of factor incomes becoming increasingly biased toward capital.[11]

Yet, in Australia, the aggregate capital-labour ratio stopped growing about a decade ago and, whilst it experienced a brief period of growth subsequently, has been falling for some years now. This is a consequence of chronically weak business investment.

The behaviour of Australia's aggregate capital-labour ratio can, in part, be explained by the resources boom. But that boom has had an impact on the functional distribution of income through a transmission mechanism that doesn't depend at all upon its impact on the aggregate capital-labour ratio.

At the start of the 21st century, China had about one-fifth of the world's population. Having been closed off from the rest of the world economy for some time, in the last quarter of the 20th century it chose to embrace market economics and international trade. Twenty years into the 21st century it had become the major trading partner of more than 120 countries, being the largest national source of imports into both the European Union and the United States. And it was buying more than a third of Australia's total exports.

Standard international trade theory predicts that a global shock of this magnitude will have a profound impact on the distribution of income, as between workers and the owners of capital, in every trading nation in the world.

Consistent with the theory, China's exports have been dominated by relatively labour-intensive products, mainly manufactures, and its imports by relatively capital-intensive products, especially minerals and energy.

According to standard trade theory, and in the absence of any border tax adjustment, like a tariff on imports or an export tax, we should have expected to see the following pattern of economic impacts in every one of China's trading partners in the developed world, irrespective of whether it ends up being a net-exporter to, or net-importer from, that country: (1) the domestic prices of labour-intensive products like manufactures fall relative to the domestic prices of

11 This is arithmetically guaranteed if all profits are reinvested (which, coincidentally, is what is implied by Phelps' (1961) golden rule of capital accumulation), both capital and labour are paid their value marginal products *and* the (absolute value of the) elasticity of substitution between capital and labour in production is less than unity.

capital-intensive products like minerals and energy; (2) the reward of labour (i.e. wages) falls relative to the reward to capital (i.e. profits); (3) labour productivity falls in all industries; and (4) relative to the owners of capital, workers are unambiguously worse off.

In contrast, Chinese workers benefit relative to the owners of capital.

Of course, there are a lot of other factors influencing relative factor prices, labour productivity, and so on. But those insights from standard trade theory do a pretty good job of describing the real economic impact on all developed nations, including Australia, of China's re-emergence as a global economic power in the first quarter of the 21st century.

As China has opened to international trade, it has experienced persistently large trade surpluses (exports exceeding imports) with the major developed economies of the United States and the European Union. These former manufacturing powerhouses, with large *trade deficits* to China, have had little difficulty seeing a direct connection between China's expansion and a decline in the living standards of their workers.

But Team Australia hasn't got it. To the contrary, we seem to believe that our sales of non-renewable resources to China and other rapidly industrialising nations in Asia have underwritten prosperity for all.[12]

Australia has experienced a persistent *trade surplus* with China.

But the distribution of the gains from international trade, as between capital and labour, has nothing at all to do with the trade balance; it has nothing to do with whether a country experiences a trade surplus or a trade deficit. It is driven, rather, by what happens to the prices of the things the country trades.

China's engagement in world trade has reduced the relative price of labour-intensive products — that is, increased the relative price of capital-intensive products — in all its trading partners.

As the relative prices of labour-intensive products have fallen, the United States and the large manufacturing nations in the EU have experienced modest reductions in their terms of trade. But because we have a comparative advantage in highly capital-intensive resources extraction, especially minerals and fossil fuels, Australia's terms of trade have increased; indeed, as early as 2012, they were double what they had been only a decade earlier.

Large increases in the terms of trade are a big deal for those charged with macroeconomic management.

Increases in the terms of trade fuel domestic inflationary pressures that increase the domestic costs of production relative to trading partners, and an appreciation of the *nominal* exchange rate. Both contribute to what macroeconomists refer to as an appreciation of the *real* exchange rate, an adjustment mechanism that takes the heat out of the economy by damaging the competitiveness of all trade-exposed sectors. Monetary policy can do little to affect the size of the real appreciation. A monetary tightening dampens domestic inflationary pressure but increases the nominal exchange rate. Effectively, the central bank can determine the distribution of the loss of competitiveness as between nominal exchange-rate appreciation and increases

12 This is the mercantilist fallacy. [Ed.]

in the domestic cost of production, but not the magnitude of the loss of competitiveness.

In the decade following the June Quarter 2002, in the first phase of the China-led resources boom, Australia's real exchange rate appreciated by 70 per cent. This had a profound impact on the competitiveness of all Australian import-competing businesses, broadly equivalent to the removal of a 70 per cent across-the-board tariff.

Over that decade, hours worked in Australian manufacturing fell by 10.3 per cent, falling from 11.4 per cent of total employment to 8.4 per cent. Over the past 20 years, Australian manufacturing has lost about 200 workers a week.

Between 2002 and 2012, mining's share of total employment, measured in hours worked, increased from 1.1 per cent to 2.1 per cent.[13]

You will probably recall that as mining exports were accelerating, our political leaders were wringing their hands over Australia's "two-speed economy." But they refused even to wonder whether the damage being done to those in the slow lane might have had something to do with the frenzy of activity in the fast lane.

The damage done to Australian manufacturing by a 70 per cent appreciation of the real exchange rate in the first decade of the 21st century could have been avoided — for example, by levying a tax on the exports of non-renewable natural resources.

The Australian Government still has an opportunity to levy a tax on our fossil fuel exports, reflecting their embodied carbon. If we don't do it, importing countries will, eventually. For example, the European Carbon Border Adjustment Mechanism (CBAM) has been designed to do so. A fossil fuels export tax levied at today's European carbon price would add many tens of billions of dollars a year to government revenues.

For an economist, it is beyond irony to witness today's leaders turn to jelly when confronted with a claim that attending to the environmental risks posed by a new mining proposal will destroy hundreds of jobs, knowing that those same leaders have done nothing to prevent the loss of hundreds of thousands of jobs in manufacturing over the past two decades. And it is simply obscene to see some of them now posturing as champions of a "made in Australia" manufacturing strategy.

But what about the impact on the living standards of Australian workers generally of China's engagement in world trade? What matters here is not whether a country's terms of trade have improved or deteriotated, only what has happened to the domestic price of labour-intensive products relative to the domestic price of capital-intensive products. Thus, even though Australia's terms of trade have moved in the opposite direction from those of the US and the major EU countries, workers in Australia have been affected in precisely the same way: labour productivity has fallen, or grown more slowly, in all sectors, and the living standards of domestic workers have declined relative to the owners of capital.

Since Australian exports are relatively capital-intensive, a doubling in Australia's terms of trade implies that, in the absence of any border tax adjustment, the relative domestic prices of labour-intensive products fall on average, by about 50 per cent. No

13 ABS, *Labour Account Australia, June 2024*. The data are seasonally adjusted "hours paid for."

other developed economy has experienced such a large negative shock to the living standards of its workers.

Note that this shock doesn't necessarily translate into a declining share of wages in gross domestic product. That's because GDP growth is also negatively impacted by weaker labour productivity growth. Thus, labour's share in GDP was 48 per cent in the June Quarter 2002 and in the June Quarter 2012.

Over the decade from the June Quarter 2002, Australia experienced staggeringly poor annual labour-productivity growth, averaging less than 1 per cent, underwriting anaemic — in some years even negative — real-wages growth. All sectors of the economy have been affected. Some will find this hard to believe, but labour productivity in the mining industry, measured by real gross value added per employee, fell by 46 per cent over the decade from the June Quarter 2002. And that has nothing to do with mining-related construction activity.

Standard trade theory says this is what should have been expected. The damage done to the living standards of Australian workers, through its impact on labour productivity growth, is not a consequence of systems designed by heartless economists, prisoners of abstract neoclassical theories. To the contrary, it is due to the steadfast refusal of legislators to take any interest in those theories.

And it is not merely neoclassical economic theory that supports a conclusion that the resources boom has undermined Australian productivity growth. One only need take a cursory look at the data. According to my calculations, the resources boom explains two-thirds of the deterioration in Australia's productivity growth performance so far this century relative to the last three decades of the 20th century (refer to the Appendix).

Capability investments in the Asian century

A focus on national endowments illuminates the need to ensure that Australians are endowed with the capabilities that will be relevant to success in the Asian century. Success will come from integration based on complementarity, not from a race to the bottom in wages, social foundations or environmental standards. In managing the risks of growing Australian inequality, there is a need for new foundational investments, including public investments: in our schools, universities and vocational training centres; in developing Asia-capable workplaces and institutions; and in encouraging adaptability.

The case for making these investments was set out in some detail in the *White Paper on Australia in the Asian Century*[14]. It explained how past capability investments provide a contemporary basis of comparative advantage. These capabilities include: excellence in governance; relatively low levels of corruption; safe working conditions; a concern with environmental sustainability and animal welfare; and institutions that support social harmony, economic and social opportunity, and tolerance. All these attributes support opportunity and freedom for this and future generations of Australians. They improve the wellbeing of the Australian people by enhancing their prospects of choosing a life they will have reason to value.

14 https://www.eastasiaforum.org/wp-content/uploads/2014/04/australia-in-the-asian-century-white-paper.pdf

But a mercantilist will argue that all are costly; that Australia's international competitiveness would be improved by ditching them. And let's not kid ourselves: all are at risk. Upon election of the Abbott Government, every discoverable printed copy of the Asia century white paper was literally pulped, and every government supported digital link to it was severed.

The structure of taxation

The tax review commissioned by the Rudd Government, early in 2008, provided an opportunity for a group of tax policy experts to consider how the tax and transfers systems might best evolve to meet the challenges of the 21st century, and to underwrite future prosperity.[15]

The review team identified challenges associated with strong population growth and population ageing; the Asian century; climate change and widespread environmental destruction; and developments in digital communications and commerce. We called out worsening housing affordability as a matter much in need of policy attention.

Our review identified the several potential sources of revenue: labour income; the normal return on capital; transactions; land; consumption; wealth; natural resources; windfall capital gains; economic rents; environmental externalities, including carbon emissions; and user charges.

We noted that placing reliance upon the first three — labour income, the normal return on capital, and transactions — put at risk the living standards of future generations by retarding productivity growth and workforce participation. We argued the case for reducing reliance on these sources and placing much greater emphasis on all others.

But understanding these things and convincing others of them are very different exercises. A nation that celebrates plunder and dumb luck, and respects "finders keepers," will not easily see a case for extracting more revenue from natural resources, windfall capital gains, economic rents or environmental externalities. It will have no tolerance of land taxes or other taxes on wealth.

The GST commenced operation on 1 July 2000. We haven't managed to sustain any tax reform effort since. There have been attempts, and they have failed. The tax-mix switch achieved with the introduction of the GST was undone in two decades, with indirect taxes contributing the same share of total revenue as in 1997–98. We are back to where we were in the several decades following WW II, that led ultimately to the Asprey Review: ill-disciplined government (which is funded by fiscal drag that punishes innovation, enterprise, and effort) is relying on a tax system that distorts the pattern of saving, and rewards tax avoidance and evasion.

The Asprey Review warned that placing exclusive reliance upon fiscal drag in the personal income tax system would threaten the social compact. There is a bigger risk now. Over the second half of the 20th century, the share of working taxpayers in the population grew strongly. Today, demographic trends are reducing the working share of the population, and the share that will be paying income tax. A heavier and heavier burden is being placed on the shoulders of a declining proportion of the population.

15 https://treasury.gov.au/review/the-australias-future-tax-system-review/final-report

There is a lot that can be said about much needed reforms to the Australian tax system. And the tax review published in 2010, devoted 1,000 pages of text to that end.

One thing worth keeping in mind as we think about tax reform requirements today is that, when we were working on the project through 2008 and 2009, we were confident that the Rudd Government's world-leading climate policy would be legislated. Its absence implies the need to explore ways in which the Australian tax system might best contribute to reducing carbon emissions and removing past emissions from the atmosphere. This is not the occasion for talking about these things, but they must be top of mind in any tax reform discussion.

Almost all the historical discourse on the fairness of various tax reform proposals in Australia has been framed in intragenerational terms; usually evaluating comparative static changes in progressivity, with current income as the denominator. In that framing, many of the much-needed reforms to the Australian tax system will be labelled regressive.

I would make two points here.

First, the interests of the most disadvantaged are not being served by a tax system that is punishing innovation, denying people opportunity, undermining economic growth, and threatening the sustainability of government service provision.

Second, and more to the point, the present tax system amounts to a conspiracy against future generations. If this generation is to make any credible claim that future generations of Australians will be better off than we are, then far-reaching tax reforms in the directions spelt out here are unavoidable.

Appendix: Australia's terms of trade and labour productivity

Looking back over the 21st century so far, there is likely to be a significant trend in Australia's productivity data, for a host of reasons that could be difficult to isolate. And the time series for productivity is also affected by large shocks, like the global financial crisis and COVID-19. But Australia's terms-of-trade were also shocked by the global financial crisis. And, if there is a strong inverse relationship between the terms-of-trade and productivity, then the global financial crisis should illustrate that relationship.

I am prepared to speculate that, in the period between the onset of the mining boom (the end of 2003) through to the onset of COVID (say, the end of 2019), most of the "other" impacts on labour productivity (i.e., other than terms-of-trade effects) might be captured in some well-behaved trendline; maybe not linear, but why not start there? So, I have deployed OLS regression on the quarterly time series data for this period (65 observations in each series; indices, Dec Qtr 2003 (t=1) = 100), returning the following estimated linear equation:

$$\pi_t = 104.0278 + 0.3372t - 0.0472p_t, R^2 = 0.9741$$

where:

π_t: the level of productivity in quarter t
p_t: the level of the terms-of-trade in quarter t
$t = [1,2,3,\dots,65]$

All coefficients are highly statistically significant (with vanishingly small p-values).

Stripping the estimated linear trend contribution from the raw productivity data produces the time series shown in the blue line in Figure 1.

This looks like something worth thinking about. It does pose a bit of a challenge to the narrative that the resources "boom" has underwritten Australian prosperity.

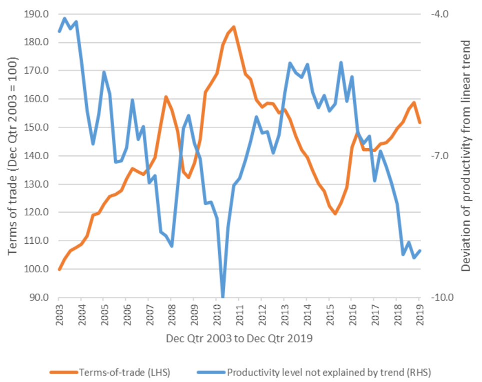

Figure 1: Terms-of-trade and actual productivity level not explained by linear trend

What if?

So, what if the terms-of-trade had not accelerated from the Dec Qtr 2003 through to its post-GFC peak in the Sep Qtr 2011?[16] Well, the coefficient on the terms-of-trade in equation (1) implies that, all else equal, the average rate of productivity growth over those eight years would have been 0.53 per cent a year larger; that is, 1½ per cent a year, instead of the actual average rate of a little under 1 per cent. For reference, Australia's average annual rate of productivity growth across the last three decades of the 20th century was 1¾ per cent.

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Questions and answers

RG: About the same time as we rejected a 20% resource rent tax (RRT), Norway imposed a 76% RRT on their oil and gas assets which was then used to create the world's largest sovereign wealth fund. What would Australia have looked like had we done something like that?

KH: Well, we would still have a vibrant manufacturing sector. The very first piece of economic advice I ever gave to the incoming Rudd government in November of 2007 was to put a big tax on resource exports. Of course, they laughed. How could a mercantilist tax exports? Are you crazy? A couple of years ago, you'll recall we had an angst-ridden discussion in Australia about what was happening to domestic gas prices. Simple high-school economics tells you that if you want to have domestic gas prices lower than world price and you are the second largest exporter of gas in the world, put a tax on your gas exports, for God's sake. It's not hard. It's pretty simple stuff, right? By the way, our gas exports will one day in the not too distant future be taxed, but not by us — because we're stupid mercantilists — they're going to be taxed by the European Union under their CBAM. They've already told us, and they've told us when it's going to start, and taxed by all of those other countries that we export to that are going to copy the European Union's CBAM. I would predict that we are too stupid and too locked in this mercantilist mindset — this narrative of Australian development — to understand that we should tax them here before they leave Australia.

Am I talking about something consequential or not? You asked about the Norwegian sovereign wealth fund. It's only back-of-the-envelope calculations but, as I said above, that tax at the present CBAM shadow price (which is really the price at which carbon credits are presently trading in Europe) would generate for Australia tens of billions of dollars a year. Why is that number so big? Well, the carbon embodied in Australia's fossil fuel exports is three times what we count as emissions from all sources: we don't count the carbon embodied in the stuff that other people buy from us in our national emissions. That's why the number is so big. I reckon the Norwegian sovereign wealth fund would be absolutely tiny relative to Australia's sovereign wealth fund.

I remember on many occasions as the mining boom was getting underway appearing in public forums and being asked the question, "Why doesn't Australia have a sovereign wealth fund?" I was always a bit surprised by the question because we were incapable of putting a tax on even just supernormal profits from the mining sector. A country that lacks either the intelligence or the courage to be able to do that, which is a rather obvious thing to do, should stop dreaming about sovereign wealth funds, certainly anything approaching the Norwegian scale.

RG: On that note, Equinox are going to invest in offshore wind in Australia and I asked them how much tax they paid last year. €80 billion, and they were still making a profit.

Q: Could there be anything more unequal than the huge lobbying sector which makes huge profits for people who employ so many lobbyists? How will we break this nexus because basically all these questions about why we're not doing things come back to the decision makers and the decision makers' perspective on things is being incredibly influenced by these organisations?

KH: It's true and of course I've had the opportunity to see it first-hand, with 28 years of policy advising in Canberra. It's actually what I referred to in Joe Stiglitz's 2013 book. It's actually what Adam Smith refers to in *The Wealth of Nations* (1776) — it's those with economic power who have the opportunity to exert political power, and the use of that political power gives them more economic power and round and round it goes, in this destructive cycle of increasing economic power, increasing political power, and so on. It has to be broken. But it's not surprising that it happens in a democracy, where political parties need to compete actively against one another — I used to think that this was only something that happened during election campaigns, but when I was working in Paul Keating's office as an advisor, which I did for five years, the ethos in the office was that you had to win the debate for the parliamentary term and that included being seen to be successful in introducing and getting legislation passed. By the time Rudd became prime minister it was every 5 minutes of every day — you had to be winning.

It's not just the politicians who are under the heavy influence of economic power and reliant upon donations from those who have the economic power — there are also the media: in the debate that we had around the resource super profits tax, I was treasury secretary at the time. I was so annoyed — it was the only time in my life that I ever did it — I called the editor of the *Financial Review* and said, "You're a joke, mate, what the hell are you doing?" Because the editorial line that was being written was the Australian mercantilist narrative — that exports of fossil fuels and iron ore are the source of Australian prosperity and only a dumbass would want to put a tax on this stuff; this amounts to killing the goose that's laying the golden eggs. His response was, "Well, every business we talk to — I guess he meant the Minerals Council — tell us that this is crazy." The role of the media is meant to be to call this stuff out, not to be complicit in it.

RC: One of the key things you framed in your talk was a lack of political will and a failure of democracy. What's troubled me in observing our political processes is the breakdown of the Westminster-style two-party system and the emergence of the smaller parties being able to hold to ransom, as it were, to achieve some kind of political concordat to break through in an electoral sense. It's how we manage that need to have the political will to do the wonderful or brave things of which you've spoken. There is also the way that the media can misdirect, courting a kind of cheap popular spirit. One of the examples is our failure to maintain public housing stock over decades, and then suddenly to point the finger at all these immigrants as somehow to blame for a lack of access to housing. It's a combination of political will, change in the democratic structure and misdirection in the press.

KH: It's a great question. I know what you're talking about with public housing. I grew up in a public housing suburb, although for some reason we didn't have a public house, but we were pretty poor — my father was a timber worker on the lowest award rate of pay in the nation — all of my school friends were living in public housing. Our lack of investment in public housing is a disgrace.

On the media: I think it's kind of interesting to see editors of established newspaper names — I say "established" but it doesn't mean they're going to be with us much longer — drawing a distinction between the traditional media — or apparently those that you can trust — and those that are threatening their existence. That's principally social media. I don't trust much that I read in the so-called traditional media; I've stopped subscribing. Maybe it's because they think the only way they can survive in this world of a hyperventilated contest is to be a participant in it and not to be different. That's how it looks to me. All those newspapers are getting thinner and thinner, except for the advertising. If the traditional media thought that they were going to be able to continue to distinguish themselves from social media, they wouldn't have started to ape them. I did ask an audience not that long ago, "When was the last time you ever read any news in a newspaper, I mean news you weren't aware of until you read it in the newspaper?" What you get in the newspapers today is commentary at best; mostly opinion — whether it's fact-based or not, it's opinion.

I don't have the answer to that but I will say this: coming back to the dysfunctional democratic system and the minor parties — Peter Shergold will remember this very well — we've had minor parties holding the balance of power in the Australian political system for a very long time. As a public servant, you had to ask yourself a lot of questions, but two in particular. One, is there any chance at all of getting this legislation through the upper house? And then the second, which is a rather more challenging question for a public servant to ask but nevertheless you do have to ask it: do we have a political leader capable of running the argument publicly?

DE: We hear of the cost of living crisis and the housing crisis. If you were prime minister, how would you solve both of those?

[Laughter]

KH: We've already had one suggestion on the housing crisis: public housing. There's no point in pussyfooting around on this one: capital gains tax preference for the family home: a $10 million house, or could be a $50 million house, sitting there on the Harbour. No capital gains tax at all. It doesn't count in the assets at all. That is one issue. The popular debate on the relationship between the tax system and housing affordability goes to the issue of what's called negative gearing. There's nothing special about somebody who owns an investment property being able to deduct the expenses associated with that investment property including mortgage interest against income from any other source. What makes negative gearing attractive is the capital gains tax, which you are expecting to pay. If you look at the rental yields that landlords get, once you take out property tax, they're in the region of 2 to 3%, which only makes sense if they are expecting a large capital gain to make up the difference to other investment opportunities. But the way the capital gains tax works is, first, you don't pay it on an accruing basis — I'm not suggesting you should: I understand the difficulties associated with that — and, second, they're not just theoretical but quite practical. Only one half of the capital gain is assessed as taxable income and taxed at your marginal rate. You don't need a very high rate of capital gain for that tax preference to be sufficiently attractive to explain why negative gearing is so popular. Australia is a standout internationally in the attraction of rental property as an investment class, relative to countries we normally compare ourselves with. It mostly has to do with those two things: first, lack of adequate public housing as an alternative for low-income rental and, second, the way the capital gains tax system works.

The proximate cause of the cost of living crisis is the wash-out from the COVID pandemic, which disrupted global supply chains in a way that nobody had foreseen. It's quite remarkable how quickly we turned from celebrating the Japanese just-in-time industrial model into "Oh my God, this is posing an existential threat to humanity," which it kind of does. We hadn't thought about the risk. COVID disrupted the supply chains, and in standard simple economics, the supply curve shifts to the left. If the demand curve doesn't shift, you'll get higher prices and inflation. What the Reserve Bank has been doing is trying to shift the demand curve to the left so that you don't get price inflation, but you do get a fall-off in economic activity. The RBA's ability to achieve that outcome without securing a recession is quite remarkable, but it does beg the question whether it might not have been prudent to wait to allow some of the adjustment to come through on the supply side.

But monetary policy can only do so much because you need to get the supply curve to shift to the right. For that, you have to be paying attention to the sources of productivity growth, for example. So maybe you should start looking at reforming the Australian taxation system in a way that drives productivity growth. That would generate two benefits that would help to address the cost of living crisis: first, it takes the pressure out of prices, and second, it provides the underpinnings for real wages growth.

GM: You mentioned how our kids are going to have the sort of opportunities that we had. Historically, there have been three sources of comparative advantage for Australia. First, the minerals sector — maybe productivity has been declining, but in an absolute sense we do pretty well at digging things up. Maybe we should process more. Second, the agricultural sector has always been important. Third, education has become quite important. Looking at where the comparative advantage for Australia might lie, how are we going to create these opportunities? Where are we going to look for employment growth, just looking at the underlying economics? Where are those opportunities going to come from?

KH: A couple of things. First, the sectors that you referred to as being sources of comparative advantage for Australia have never been drivers of employment growth. The mining sector has never employed more than 2.5% of the labour force, and that was in a boom time. Historically, it has employed between 0.9% and 2.1% of the Australian labour force. Mining has been a great driver of exports, but it has distributed very few benefits to Australians because very few Australians work in mining. In the national accounts, there's only one thing that has a higher capital-to-labour ratio than mining, and that's something called "ownership of dwellings." That's because it's got no labour in it; it's all capital. But if you ignore ownership of dwellings, mining has a capital-labour ratio that is several multiples of anything else. It doesn't contribute to the living standards of Australian workers, and at least three-quarters of the shares in the big multinational companies that exploit Australia's natural resources are foreign-owned, so foreign capitalists get most of the benefit. Some does come to Australian superannuation funds and beneficiaries, although Australian superannuation funds have long acted on the basis that they can get higher returns offshore than in Australia. Even in the middle of the global financial crisis, they were investing 35% of their assets in foreign equities, mainly in the United States. So we must ask ourselves more fundamental questions, and some of the answers you suggested are right. We do have to look at our education system and at building what I call Asia-relevant capabilities. In the Asia-Century White Paper, we had the Australian government signing up to a proposition that by some year every Australian school child would have the opportunity to learn an Asian language. Where did that go?

It is not too late to turn some of this around, but I don't see any of our current politicians capable of constructing a narrative that would carry the day. If I were prime minister, I would actually put a tax on Australia's fossil fuel exports equal to the rate the Europeans are going to tax them at within two years' time. I would raise tens of billions of dollars a year and I would spend that on national development — rebuilding the productive capacity of the country — and I would do more than that. With respect to meeting our own Net Zero by 2050 ambition, I would direct very substantial amounts of funding to rebuilding the quality of natural capital across Australia, including in heavily degraded farming areas. I know how to do it: a group of us have modelled this piece of policy work, as good as anything in the world. I know a way through our carbon policy to generate $10 billion a year to invest in nature repair across the Australian landscape, most going to farmers. We can do these things; they're not that complicated.

IS: I want to ask about taxation. I think that many of us in this room are drawing pensions. It is ridiculous that we don't pay any tax on pensions. That's something I never hear about because it's probably so unlikely. I know the grey vote is very important, but I think pensions should form part of taxable income.

KH: They do for me because I'm one of those lovely public sector superannuation schemes. There's a lot in it. When you consider the taxation of superannuation, there are three taxing points. One, there's how much tax is paid when wages and/or salary or any other form of income are sacrificed and instead of being used to finance current consumption are directed into this tax-preferred savings vehicle called the superannuation fund — that's the contributions tax. Two, there's the tax on the fund earnings: how does that taxation rate compare with the taxation rate on a bank account balance or dividends or rental property investment or whatever, all of which apart from the bank account are tax-preferred?

Three, there's the one that you mentioned, which is when you make a withdrawal, how much tax do you pay? Now, when you withdraw money from the bank account, you don't pay any tax. Firstly, it's because when you put the money into the bank account the assumption is that it was fully taxed income, and you're only putting money in out of taxed income; secondly, the interest income is fully accessible whilst it's in the bank account and so it would be madness to tax it on the way out as well. But how does superannuation compare with that? It's obviously tax-preferred. Like a bank account, there's no tax on what you take out. There is a concessional rate of tax on the contributions going in, although that's no longer a single rate of 15% and depends upon your income, and there's tax on the earnings inside the superannuation fund, and again, that's not a single rate of tax: that also will depend upon the account balance. But curiously — here's the thing that I really do not understand — if you are a pensioner like yourself getting money out of the superannuation fund, then what I've just said about the earnings is not true. They're actually exempt from tax: the earnings inside the superannuation fund are exempt from tax. You're drawing a pension in the pension phase. I have never been able to get my head around that. I cannot understand that one at all. It makes life rather complicated for the superannuation funds because they have to decide which of the earnings are referable to which pool of assets that are referable to the pensions being paid out, and which are not. Anyway, we've created that system. In the tax review, we recommended getting rid of that exemption so that all earnings are subject to tax, and then, if you want to reduce the concessionality of the superannuation system, you either work with the contributions tax or the earnings tax, or you think about a more comprehensive wealth tax, but we didn't recommend it. We just said to think about a more comprehensive wealth tax, and that might be the only way of achieving the level of equity or fairness that you referred to.

DH: You referred just a moment ago to wealth tax in the Henry Report but no recommendation, just saying there should be a public debate. You also referred to Piketty's work, which says that the returns to capital are greater than the returns to labour. Australia has done something of a job in rectifying that by making everyone who has a compulsory superannuation account a capitalist. I recently did a back-of-the-envelope calculation: if you taxed at 5% the top 200 wealthiest people in Australia, you could put $5,000 a year into savings accounts for every single child in Australia. If you did that from the date that they were born until they turned 18, they'd have nest eggs of about $100,000 each, which could very well make the difference between owning a house by the time they retire and not owning a house. Any ideas on wealth tax generally?

KH: You're right. When we wrote the review, we referred to wealth taxation, but we didn't make a recommendation. We did say there was a need for public debate on a wealth tax. We haven't had it, although maybe you could argue that the housing affordability crisis is some form of debate on a wealth tax, but I don't think it is really. I think there is a need for Australia to have that sort of debate on a wealth tax. I don't know what the public appetite is. I'd like to see it tested, but I don't know. I think it's because of what I said earlier — maybe there are other explanations for the way that we have behaved as an electorate over many years — but I really do think it is the case that we interpret "fair go" as plunder, dumb luck, and finders keepers, and you should never take any money away from somebody, no matter how they got it, unless it was through criminal activity. The celebration of plunder: I was kind of shocked when I witnessed first-hand the efficacy and the power of the Minerals Council's campaign against the resources super profits tax — the biggest, most profitable companies in Australia — and a government that was in reasonable political position at that time. So there is something in the Australian psyche that does not like to see wealth taken from anybody. I've often wondered how much of this goes back to the Eureka Stockade. The reason I say that is it was not until 1987 that any activity associated with gold mining paid 1 cent of tax. One of my distant relatives, long gone past, is associated with the Stockade and ended up being Minister for Mines in Victoria; he also started the *Daily Telegraph* here in Sydney. That explains a lot.

Q: I am wondering if you might comment on the prospect or realistic hope of some sort of loose alliance between government or involvement by government between those market forces that might provide a counterweight to the kind of interests or mindset that you've described, and civil society as well. For example, the farmers in that natural capital example you mentioned presumably are a kind of political economic voice or power that could be brought to the fore. But the renewable sector — you can go on and on — manufacturing sector. Do you see any realistic sort of prospect of a counter movement?

KH: Great question. What's implicit in your question is that it must be possible to marshal those interests who benefit from change to be a force for good rather than a force of opposition. Here's something to reflect on. About a month ago, the Climate Change Authority released its report on its carbon projections for the six sectors that make up the Australian economy: what will happen to the carbon emissions out to 2050 under the government's six sectoral decarbonisation strategies that they're developing independently. Just a little bit about the composition of Australia's carbon emissions at the moment. As you know, the landscape naturally sequesters carbon: if you just leave it alone, it will absorb carbon in the growth of vegetation, grasses, and soil and peat, and all that kind of stuff, right? That's how the carbon got there in the first place before we interrupted. That's a natural process that in Australia today is sequestering 90 million tonnes of carbon a year, but everything else that we're doing — including the cows belching methane but also all the industrial processes — and excluding all the carbon embodied in the fossil fuels that we export and get somebody else to burn rather than us contributes 520 million tonnes of carbon a year to our emissions. So our net emissions are 430. That's our starting point when we say we're going to get to Net Zero by 2050; we're saying that 430 has to get down to zero. So the Climate Change Authority has asked itself this question: let's forget about the land sector for a moment; where do we think the five other sectors plus agriculture are going to end up by 2050 if the government does everything that the government appears to be wanting to do and we make use of every known technology, etc.? Answer: they reckon that we can get the 520 down to 130. That's pretty incredible. But the other way of looking at it is that land, instead of absorbing 90, is going to have to absorb 130 million tonnes of carbon a year. Actually, that's a bit of a fiddle on my part because they do say, "Oh, but it won't have to absorb as much if we combine some new technology that can draw carbon out of the atmosphere like direct capture." Unless you can find some new technology of that sort, then the agriculture sector is going to have to absorb 130 million tonnes, the length rather than 90. That's a big increase in carbon sequestration in the Australian landscape. I look at that and I say, "Fantastic opportunity — a new revenue stream for farmers." The president of the National Farmers Federation obviously had the press release loaded in the barrel, so as that report came out, the press release bang — it was out and it said, "No way are we having more trees across Australia's farms." I still agree with you; we're going to have to talk to farmers and the National Farmers Federation, but it's not easy.

CS: We could not have had a better case of a public intellectual contributing to civil society than you've given us today. I wanted to say just one slight personal note: my mother was an economist in Peter Karmel's group at Flinders, and just before she died in 2009 she said, "Look, things are going to be okay: wholesale reform of taxation — the white paper is out. Thank God, it's going to be fine." Very sadly, she died at the end of that year, but I've always felt glad that she thought we were going to be okay. I'm just amazed at your ability to come across these wide areas. I remember reading you saying somewhere that fuzzy concepts can be measured. Now, I didn't do economics; I went into logic, and I used to do fuzzy logics. We had fuzzy logics that went fuzzy all the way down. There are much better mathematicians than me here who could explain it, but what happens with you is that you're not fuzzy all the way down. I've never heard such clarity of talk, and again it takes me back to Karmel and Wallace and Harcourt around the dinner table. They used to talk deep into the night, always with this combination of a sense of social responsibility, looking for the good of society. Very clever economists but with this clarity and sense of responsibility, which I think is even more important now than ever. I also want to say something about your turn of phrase, which is just extraordinary. I started writing them down as you got going, and then my scribbles got incomprehensible, but certainly "a fair go is plunder, dumb luck, and finders keepers." I don't think any of us will ever forget that, or we idolise those who plunder the most, and quite a lot of your other unbelievably elegant phrasing I think has helped us. I think we have come out of this with a sense that at least we've got people thinking through these questions and dealing with them. From our point of view, I think that's what we think we have to do. So I'm extremely grateful, and I'd like you to accept a copy of the history of the Royal Society, which has tried to address these issues — not always in the best way; we've got some pretty black passages in our history, in particular in dealing with Indigenous people — but it's a story of people who are trying to do the best. So thank you very much indeed.